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In the Supreme Court of the United States

No. 79-142

SUPERIOR COURT OF CONTRA COSTA COUNTY (WELLS FARGO BANK, ET AL., REAL PARTIES IN INTEREST),

Petitioner,

VS.

SUSAN GARFINKLE, ET VIR,

Respondents.

RESPONDENTS' BRIEF IN OPPOSITION

On Petition for a Writ of Certiorari to the Supreme Court of the State of California

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OPINIONS BELOW

On November 7, 1978, the Superior Court of the State of California effectively refused to enjoin a foreclosure sale of respondents' home and granted summary judgment to petitioner Wells Fargo Bank. On March 5, 1979, the California Court of Appeal ordered that the foreclosure sale be enjoined without condition and that the summary judgment be vacated. Appendix A to the Petition. On May 3, 1979, the California Supreme Court denied a hearing. Appendix B to the Petition.

None of the opinions have been or will be published, and all of them are silent as to the federal question urged in the petition for writ of certiorari.

JURISDICTION

We question whether petitioners have satisfied the jurisdictional requirements of this Court, for the reasons set forth *infra* in Section 1 of the Reasons for Denying the Writ.

QUESTIONS PRESENTED

1. Should the petition be entertained despite the failure to raise the federal question in conformance with state rules and the rules of this Court, so there is no adequate record, and the opinions below are silent as to the federal question?

2. Does the petition correctly describe the California Supreme Court's decisions?

3. Should this Court reconsider the long-standing rule, permitting states to apply judicial decisions to existing contracts, in a case where the state court merely construed a pre-existing statute and did not alter the prior law in any respect material to the case?

4. Does the United States Constitution prevent such an application where the decision supports the reasonable expectations of the contracting homeowners, while preventing the Bank from unilaterally changing its practices so as to obtain unbargained-for windfall profits?

STATEMENT OF THE CASE

For more than two decades, Wells Fargo Bank has utilized a due-on-sale clause in its real estate loan agreements. Prior to 1965, it used the clause solely to protect its security interests in the event a borrower sold the property under circumstances that impair those security interests. Even that limited use of the clause was doubtful under California statutory and case law prohibiting restraints on alienation. In 1964, the California Supreme Court held that a similar provision was permissible because it was a reasonable device to protect the lender's security interests. See Section 2, *infra*. In 1965, Wells Fargo started using the due-on-sale clause for reasons that were not related to protection of the security. In particular, the Bank began to use the clause as leverage for coercing admittedly creditworthy purchasers to pay increased interest rates and fees in order to avoid losing their homes through nonjudicial foreclosure sales.

In 1964, Michael and Gayle Lanning financed the purchase of their home through a $13,000 secured loan from Wells Fargo Bank. In 1967, the loan was revised to $19,500. The Bank did not alter the due-on clause or inform the Lannings of the 1965 change in its practice. In 1969, when the Lannings listed the property for sale, they believed and represented that the loan was assumable at its existing interest rate. Respondents agreed to purchase the property, with an assumption of the existing loan. Wells Fargo then informed re-

spondents that it would insist upon increasing the interest rate by 2¾% as consideration for waiving its purported right to foreclose. Wells Fargo has admitted that its security interests are satisfied and that its sole purpose is to use the due-on clause as leverage to obtain higher interest payments.

On January 23, 1970, respondents closed escrow while continuing to attempt to resolve the matter with the Bank. They advised the Bank that they would comply with any final judgment if the Bank desired to litigate the issue, without the need for foreclosure. They have made all monthly payments due under the note to this date. Nevertheless, on June 9, 1970, Wells Fargo initiated a nonjudicial foreclosure. They thereby forced respondents to seek injunctive relief in the federal courts, since state courts, at that time, believed that 12 U.S.C. §91 prohibited state preliminary injunctions against national banks.

While respondents were preparing a motion for an injunction, Wells Fargo agreed that it would not foreclose while the litigation was pending. In reliance thereon, respondents did not request the injunction. The district judge granted a motion to dismiss the federal action. The Ninth Circuit reversed; but it also ordered abstention, directing respondents to litigate in the state courts. *Garfinkle* v. *Wells Fargo Bank*, 483 F. 2d 1074 (9th Cir. 1973).

While the state litigation was pending, a status conference was called by United States District Judge William Orrick. As a result, counsel for all parties stipulated that Wells Fargo Bank would not attempt to foreclose "until final judgment or other final disposition of the state proceedings" and for 30 days thereafter. On May 1, 1975, the stipulation was expressly relied upon by Judge Orrick in dismissing the federal action with respondents' consent.

In 1974 and 1975, the state trial court overruled the bank's demurrers on the due-on-sale clause issue. However, it ruled against respondents as to the constitutionality of nonjudicial foreclosure. On May 16, 1978, the California Supreme Court upheld the trial court on the constitutional issue, ruling that the procedure is "private action." *Garfinkle* v. *Superior Court*, 21 Cal.3d 268 (1978). Respondents appealed to this Court. On November 6, 1978, the appeal was dismissed for "want of a substantial federal question." Mr. Justice White and Mr. Justice Marshall stated that they would note probable jurisdiction. 439 U.S. 949 (1978). See generally Grijalva, *Garfinkle* v. *Superior Court: No State Action in Nonjudicial Foreclosure*, 67 Cal.L. Rev. 684 (1979).

In the earlier decision, the California Supreme Court observed that Wells Fargo had agreed not to foreclose until the litigation was resolved, that the due-on issue was still pending, and that it also was pending in *Wellenkamp* v. *Bank of America*. *Garfinkle*, 21 Cal.3d at 273 n.3, 274 n.5. *Wellenkamp* was decided on August

25, 1978. 21 Cal.3d 943 (Appendix C to the Petition). It upheld the legal theory that respondents had urged for more than eight years. It added: "However, given the importance of the stability of real estate titles. . ., we hold that this decision shall not apply when the lender, prior to the date that this decision becomes final, has either enforced the due-on clause, resulting in sale of the subject property by foreclosure or in discharge of the acceleated debt. . . ." Appendix C at p. 17.

Despite the stipulation and federal court order, Wells Fargo prepared a "Notice of Trustee's Sale," which designated the sale date as September 22, 1978 (before *Wellenkamp* would be final), and stapled it to respondents' house. On September 14th, the trial court restrained the trustee's sale, but with the condition that if an injunction ultimately were denied, then the date of sale would be considered to be prior to *Wellenkamp's* being final. On November 7th, the trial court granted summary judgment to the Bank. It also "granted" a preliminary injunction to respondents, but only until this Court's action on the earlier case became final.

The Bank did not raise any federal question during the trial court proceedings; none of the parties made a factual record as to such issues; and the trial court did not address them.

On March 5, 1979, the California Court of Appeal granted a writ of mandate to respondents. The opinion

did not address the federal question; nor did it state the facts necessary for such a decision. Appendix A. Nevertheless, as shown in the next section, petitioner did not comply with reasonable court rules for the preservation of such issues for review by the California Supreme Court or by this Court. On May 3, 1979, the California Supreme Court denied a hearing without further comment. Appendix B.

REASONS FOR DENYING THE WRIT

I. The federal question is not properly before this Court.

Petitioner has failed to follow reasonable state procedures to secure a decision of the highest state court in which a decision could be had, within the meaning of 28 U.S.C. §1257. It also has failed to comply with Rule 23(1)(f) of this Court.

In deciding whether to grant a hearing, the California Supreme Court relies upon the statements of fact and issues set forth in the Court of Appeal decision: "On petition for hearing the Supreme Court will not examine the record for error unless the petition shows that substantial issues of law or fact were incorrectly stated or were not considered in the opinion of the Court of Appeal *and* that such issues were raised in the briefs *and* set forth in a petition for rehearing in the Court of Appeal." Cal. Rules of Ct., Rule 29 (b) (emphasis added). In this case, the Court of Appeal neither addressed the constitutional issue nor stated the facts that are relevant and necessary to resolve it.

Nevertheless, Wells Fargo did not file the required petition for rehearing; nor did its petition for hearing set forth any of the information that was required for the Supreme Court to examine the record and decide the issue.

Indeed, the record would not have been adequate for an appellate decision, since petitioner *also* had failed to raise the federal question in the trial court. As a result, the record is sparse or non-existent as to the facts that the Bank would have to establish. These include, *inter-alia*, the relevant contract date, the nature and purpose of the provision, the custom and practice, the reasonable expectations and reliance of the contracting parties, and the circumstances and effect of Wells Fargo's unilateral change in its practices regarding the provision.

Since the decisions below are silent on the federal question, the California courts are presumed to have declined to address it because of the failure to raise the question properly. *Bailey* v. *Anderson*, 326 U.S. 203, 206-207 (1945); see generally Stern & Gressman, SUPREME COURT PRACTICE at pp. 205, 214-218 (5th Ed. 1978) and authorities cited therein.

Perhaps as a result of these failures, petitioner's statement of the case also fails to comply with Rule 23(1)(f) of this Court, in that it does not specify the stage in the proceedings nor the manner in which the federal question was raised, nor the method of raising it, nor the way it was passed upon, nor such pertinent

references to the record "as will show that the federal question was timely and properly raised so as to give this court jurisdiction to review the judgment on writ of certiorari."

2. The petition misstates the holding and effect of the California Supreme Court's decisions.

Wells Fargo Bank contends that the California courts have taken away a contract right that it possessed when it entered into its contract with the Lannings. In particular, the Bank contends that *Wellenkamp* v. *Bank of America* "invalidated" the due-on-sale clause, and overruled *Coast Bank* v. *Minderhout*, 61 Cal.2d 311 (1964), which its attorney says the Bank had relied upon.

This view of the California decisions is contradicted by the language of the California Supreme Court itself:

(a) Prior to *Coast Bank*, there was considerable doubt as to whether the due-on-sale clause was enforceable for *any* purpose. See *Schneider, Debtor-Selection Provisions Found in Trust Deeds and the Extent of Their Enforceability in the Courts*, 35 S.Cal.L.Rev. 475, 476 (1962). See also cases cited in *Coast Bank*, 61 Cal. 2d at 315-316.

In *Coast Bank*, the Supreme Court declared a limited exception to the general rule prohibiting restraints: "The provision that the Enrights would not transfer the property without plaintiff's consent is a restraint on

alienation. [It] has frequently been stated that any restraint on alienation is invalid. [¶ This view] needlessly invalidates reasonable restraints designed to protect justifiable interests of the parties. [¶] . . . A restraint on alienation in an executory land contract has been upheld because of the vendor's interest in the upkeep of the property and in the character and integrity of the purchaser. In the present case it was not unreasonable for plaintiff to condition its continued extension of credit to the Enrights on their retaining their interest in the property that stood as security for the debt." *Coast Bank*, 61 Cal. 2d at 315-317 (citations omitted). See also *Wellenkamp's* description of the earlier case: "Our decision in *Coast Bank* v. *Minderhout* recognized that this rule was not absolute in its application, but farbade only *unreasonable* restraints against alienation. In determining whether a due-on clause was unreasonable in *Coast Bank*, we looked at whether the restraint was *necessary to prevent impairment to the lender's security*. We concluded that the restraint was *reasonable in that case*." *Wellenkamp*, Appendix C at p. 9 (emphasis partially added; citation omitted).

In *Coast Bank*, the lender did accelerate and foreclose upon learning of the sale. The property owner challenged the provision on its face, without regard to the purpose or circumstances of enforecement. The decision does *not* authorize a lender to use the threat of foreclosure as a means of increasing its bargained-for profits, at the borrower's expense, in a way that has

nothing to do with the justifiable interests for which the exception was created.

(b) Unlike *Coast Bank*, the issue in *Wellenkamp* was *not the facial validity* of the provision; it was the the *circumstances and procedure* under which it could be enforced: "Plaintiff contends that this clause is unenforceable absent a showing by the lender of impairment to its security; whereas defendant contends that it can automatically enforce the clause without any further showing." *Wellenkamp*, Appendix C at p. 9.

(c) As petitioner correctly states, subsequent decisions followed *Coast Bank* in upholding due-on-sale clauses, but they did so "*because such a provision is necessary to the lender's security.*" Petition at p. 5, quoting *La Sala* v. *American Sav. & Loan Assn.*, 5 Cal. 3d 864 (1971). In particular, the California Supreme Court expressly repudiated the contention that a due-on clause could be used to coerce increased profits rather than to protect security interests: "As we stated in *La Sala*, '. . . a restraint on alienation cannot be found reasonable merely because it is commercially beneficial to the restrainor.' " *Wellenkamp*, Appendix C at p. 16. Accord, *Tucker* v. *Lassen Sav. & Loan Assn.*, 12 Cal. 3d 629, 636, 640 (1974).

(d) Petitioner states that *Wellenkamp* overruled *Coast Bank*, but the overruling was expressly limited "to the extent inconsistent with this opinion." *Wellenkamp* Appendix C p. 17. The partial overruling refers to the practice of "automatic performance" of the due-

on clause, i.e., enforcing the clause, *to protect security*, without actually investigating the circumstances and being able to demonstrate that enforcement is in fact necessary. *Coast Bank* tacitly approved the practice because the lender had not demonstrated actual impairment. The change made by *Wellenkamp* is that *the lender now must undertake the burdens of investigation and proof on the security issue before enforcing the clause.*

Our case does not turn on the distinction between *Coast Bank* and *Wellenkamp*. Here, Wells Fargo did *not* automatically enforce the due-on-sale clause. It *affirmatively satisfied itself that the security was protected*, and it threatened to accelerate for *the sole purpose of coercing higher interest payments* from admittedly acceptable purchasers. For these reasons, the trial court in our case ruled that respondents had stated a cause of action long before *Wellenkamp* was decided. See Appendix A at p. 1.

(e) Similarly, the limitation on *Wellenkamp's* last paragraph, limiting its applicability where there had been completed foreclosure sales, loan payoffs or modifications was *not* a determination that Wells Fargo's conduct was legal before *Wellenkamp*. The Supreme Court simply recognized "the importance of the stability of real estate titles and the interest in preserving completed real estate financing arrangements" (Appendix C at 17) and determined that the decision would not be used to upset those events that had already been

completed before *Wellenkamp* clarified the "automatic peformance" issue. See also Hetland, *After Wellenkamp, Part Two: Retroactivity*, Calif. Real Estate 36 (Jan. 1979) (explaining the limitation and describing this very case: "Wells Fargo's astonishing performance seems more nearly a contempt than an alert reaction to a last chance to grab Garfinkle's house.")

3. This is not an appropriate case for reconsidering the decisions which hold that the states may apply judicial decisions to existing contracts.

Petitioner asks this Court to reconsider the long line of cases that held that the Federal Constitution permits retroactive application of judicial decisions, even where contracts were made on the faith of contrary case law. See, e.g., *Tidal Oil Co.* v. *Flanagan*, 263 U.S. 444, 451 & n. 1 (1924) (citing 19 such cases more than half a century ago) ; and see cases cited in the Petition at p. 9.

Respondents are prepared to defend these decisions as both necessary and proper. Indeed, a ruling that court decisions may not be applied to existing contracts would effectively immunize even the most obsolete, erroneous or short-sighted decisions and lender practices. Few homeowners will risk litigation if they cannot benefit from a successful challenge.

It is not appropriate, however, for this Court to reach the federal question, since the California Supreme Court has *not* retroactively invalidated a contract provision that had been entered into on the faith of an earlier decision. Several points illustrate this fact.

(a) Contrary to petitioner's assertion, the relevant contractual relationship was established in 1964. In 1967, the terms were merely revised, without any change in the due-on-sale clause. In 1964, petitioner had an established practice of using its due-on clauses only as a security-protection device. It changed the practice in 1965, but did not inform the Lannings of the change. In 1969, the Lannings still believed that there would not be any acceleration if they sold the property to persons who protected the Bank's security interests.

(b) As shown in Section 2, *supra*, the decision which Wells Fargo says it relied upon, *Coast Bank*, did not approve the conduct employed here. *Wellenkamp* did not change the law in any respect that is material.

(c) In all of the decisions, the California Supreme Court was interpreting a long-standing statute (Civil Code §711, as enacted in 1872 and set forth in *Wellenkamp*, Appendix C at p. 9), which had been used to prohibit the use of similar provisions prior to *Coast Bank*. See cases cited in *Coast Bank*, 61 Cal. 2d at 315-316. *Wellenkamp* simply construed the contract, as qualified by the statute, under circumstances that *Coast Bank* neither foresaw nor addressed.

4. The new rule does not impair any right in the constitutional sense.

Even if petitioner were correct in characterizing *Wellenkamp* as retroactively altering the rights that existed at the time of the contract, and even if the constitutional prohibition against legislative impairments is now to be applied to judicial decisions, the change involved here would not be unconstitutional.

This Court has repeatedly held, and recently reaffirmed, that states may enact legislation that " 'restrict a party to those gains reasonably to be expected from the contract' when it was adopted," preventing lenders from obtaining "windfall benefits" contrary to the expectations of the borrowers. *United States Trust Co.* v. *New Jersey*, 431 U.S. 1, 31 & n. 30 (1977), and cases discussed therein. See also *id.* at 20, n. 17. That is essentially what the California Supreme Court determined would be the effect of permitting lenders to use a due-on-sale clause for the purpose of coercing an increase in the bargained-for interest rates and fees: "[It] would not further the purpose for which the due-on clause was legitimately designed, . . . [and] it would be unjust to place the burden of the lender's mistaken economic projections on property owners exercising their right to freely alienate their property. . . ." *Wellenkamp*, Appendix C at pp. 15-16.

Moreover, this Court has said that it "must decide for itself whether there was a contract, and whether the law, as enforced by the state court, impairs it." *Tidal Oil Co.* v. *Flanagan*, 263 U.S. at 453. In this case, the opinion below does not state any of the facts that will be necessary for such an assessment. The record, although incomplete as a result of the Bank's failure to raise the issue in the trial court, tends to establish that

there was no impairment of any contract. The contracting homeowners expectation, set forth in a sworn declaration, was precisely what *Wellenkamp* declared the law to be. Exhibit 12-A. Indeed, at the time of the original contract, the Bank's practice was to use the due-on-sale clause only for the protection of its security interests, which was in accordance with the homeowner's reasonable expectations and was "the purpose for which the due-on clause was legitimately designed. . . ." *Wellenkamp*, Appendix C at p. 15.

The record does not contain any competent evidence to the effect that the Bank had contrary expectations or reliance. Wells Fargo asks this Court to determine that there was an impairment of its contract rights solely on the basis of the unsworn and unsupported statement of its attorney, in the face of substantial evidence to the contrary.

CONCLUSION

For the foregoing reasons, the petition for writ of certiorari should be denied.

Dated: November 21, 1979.

Respectfully submitted,

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